



FINANCIAL LITERACY

TO ACHIEVE YOUR
FINANCIAL WELLBEING

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01

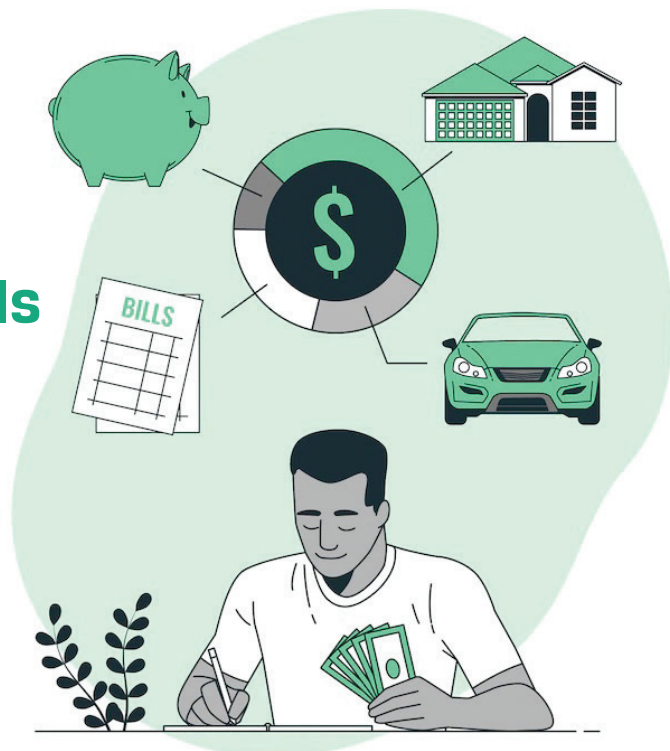
DEFINITION AND BENEFITS OF FINANCIAL LITERACY

Definition of financial literacy

Financial literacy can be defined as a combination of financial knowledge, skills, attitudes and behaviors necessary to make sound financial decisions, based on economic and personal circumstances, to improve one's financial well-being, where:

- "Knowledge" means having an understanding of personal financial issues;
- "Skills" means being able to apply that knowledge to manage one's personal finances; and
- "Attitudes and behaviors" means settled beliefs, feelings, confidence and biases during particular situations relating to handling one's personal finances.

Financial literacy is "The ability to use knowledge and skills to manage one's financial resources effectively for lifetime financial security"



Benefits of financial literacy

Financial inclusion, which is giving people at all levels access to the financial system of a country, can only be effective if individuals are aware of the risks they are taking and are prudent in how they make use of financial services. In Sri Lanka, low financial literacy has led to a high level of indebtedness and people making risky investments such as in pyramid schemes.

Sri Lanka has the highest gap between print literacy and financial literacy in the region. On average, 65% of adults in advanced economies are financially literate. South Asia records the lowest percentage of financial literacy, with Sri Lanka coming in at about 35%. Evidence shows that Sri Lanka's low financial literacy is spread across all social strata from the poor to the professionals such as doctors, lawyers, and judges.

Many dishonest organizations operate illegally or outside of the legal framework in Sri Lanka. They either mobilize high interest-paying deposits or offer informal lending schemes that provide loans at exorbitant interest rates and thrive on the financially illiterate who, because of their sheer lack of financial knowledge, only focus on their short-term needs and do not understand the long-term consequences of their decisions.

"Financial inclusion, which is giving people at all levels access to the financial system of a country, can only be effective if individuals are aware of the risks they are taking and are prudent in how they make use of financial services."

- When people face financial stress, their immediate reaction is to look for more money. They believe that the solution to the problem they are facing today is to go after more money but they do not understand that the root cause of their problem is their low financial literacy. Such "solutions" will drag them deeper into financial stress.

- Being financially literate clearly benefits individuals and their households, since they are able to make better and more informed decisions when it comes to saving and borrowing money. They will be able to prioritize their needs more efficiently and build a pool of funds for future use or borrow money with a clear understanding of the borrowing costs and their capacity to repay the borrowings, within a reasonable period.

- People who make sensible financial decisions are more likely to achieve their financial goals, manage financial risks, build a pool of financial assets, not become a burden to society, and contribute to the economic growth of the country.

- Money comes and goes, but if you are financially literate about how money works best, you gain power over it and can begin building wealth.

- The first and most important step is to educate yourself to become skilled at making, controlling and safeguarding your money. You need to start working on your financial IQ and become financially literate so you have the freedom to achieve your objective successfully.

02

HOW TO ACHIEVE FINANCIAL INDEPENDENCE AND WEALTH



"Wealth is a person's ability to maintain their lifestyle for a lifetime if they were to stop working today"

The education system teaches people to study hard, achieve good qualifications and get a well-paid job. In other words, how to work for money, but they do not teach you how money can work for you. This lack of financial skills within the school curriculum means that even highly educated people generally do not know how to manage money. The result is that the majority of people get trapped in work to pay their bills and are chasing paychecks all their life. There are many accountants, doctors and lawyers who work very hard, but they never seem to earn enough and are in this rat race.

The fundamental problem with working for money is that a job is a short-term solution to a long-term problem. People believe that if they get that raise, or get a new job, they will finally have enough. However, if you do not know how money works, you can never have enough. Money alone will not solve anything. Most people, given more money, only get into more debt.

People are not taught at school how to spend their money wisely. Many do not know the difference between an asset – something which puts money in your pocket, and a liability – something which takes money out of your pocket. The only way to become financially independent is to accumulate income-generating assets that can pay for your expenses. Smart people diligently build their assets such as fixed deposits, bonds, unit trusts, stocks, income generating real estate, anything that produces income or appreciates in value and has a ready market, that generate income. However, many people would rather buy a smart phone on installment basis (taking a loan, i.e. creating a liability) instead of investing that money in assets that generate income that would finance their smart phone. If you do not want money to control your life, as it does for most people, then you will have to do things differently from the crowd.

You can achieve financial independence at any age if you follow a certain process and commit to it. How fast you are going to achieve success depends on two things:

1. How much money you need every year to cover your expenses
2. How determined and focused you are about building a portfolio of cash-generating assets to cover those expenses.

Anyone can do it, provided you discipline yourself to live within your means and build your assets. Most people want the convenience of financial freedom but only a few go through the inconvenience of achieving it.

The poor work for money. Many people find that their expenses always keep up with their income. They do not understand why even if they earn more than they used to, they still have no money left at the end of the month. They struggle financially because when their income increases, they continue to increase their spending. However, their assets do not increase, but their liabilities do! They work to make their organization rich, they work for the bank to pay off their debts and they work to pay government taxes. Working harder means that you will have to hand over an even bigger share of your efforts to these three parties.

Rich people are rich because they live like the poor. On the contrary, poor people are poor because they try to live as if they are rich. Do you want to be rich or look rich? Think about it. The rich get richer because their assets generate more than enough income to cover their expenses, and part of the income is then reinvested into new assets, therefore increasing the generated

income even further. Reinvesting income into new assets triggers the power of compounded interest, to which Albert Einstein once famously referred as the "eighth wonder of the world, because those who understand it, earn it those who don't pay it." The wealthiest and wisest investors are always smiling, because they are making money every second of the day.

A small piece of snow becomes a powerful force such as an avalanche when it starts coming down a hill and gathers more snow over time. Your wealth works the exact same way. The work you need to do in the beginning is often very painful and requires a lot of discipline. You don't see results overnight. But once your wealth snowball is built, your wealth naturally attracts more wealth. Then the power of compounding interest can work in your favor. Just as a snowball compounds and grows over time, so can your wealth. Nothing can stop it from growing. As long as an investment is paying you interest, you can keep smiling at night because you know that time is your ally. The longer the time you have, the richer you get!

Compounding interest can create millionaires from average people, especially if you are young! Take an average 25-year old saving Rs.287 per month and earning 12% compound interest, she or he would have a Rs.1 million by 55! This is just assuming conservative 12% returns in a fixed deposit, and assuming she never gets a raise and save anything more over the 30 years. The real results could be much greater! By investing in companies that are growing – thus paying out increasingly more cash to shareholders, an initial investment could multiply many times over in the course of a long time span. Don't underestimate this power of investing.

This is all due to compounding interest explained in the section "Compound interest is your greatest friend" later.

A list of income-generating assets to give you some ideas:

1. Fixed income instruments that pay an interest rate higher than the rate of inflation.
2. Rent-generating real estate that appreciates in value over time.
3. Businesses that you own that do not require your presence all the time but are managed well enough to be successful and profitable.
4. Good dividend paying Unit Trusts that appreciate in value over time.
5. Good dividend-paying stocks that appreciate in value over time.



"You become financially free, when your passive income exceed your expenses"

Key lessons to help achieve financial independence and wealth

These key lessons will help you achieve a life where you are no longer dependent on your salary and you progressively become wealthy:

- 1.** What you learn will help you become what you are, so choose what you learn and read carefully. Find people who are the best in their field. An investment in knowledge pays the best return. You are making an important investment by just reading this booklet.

- 2.** Do not simply aim for more income, aim for more assets. Keep your expenses low and reduce your liabilities.

- 3.** If you want to buy something, first generate enough cash flow from your assets to cover the cost of your acquisitions and expenses. Learn to prioritize your needs where the purchase of luxuries would only be pursued after you have acquired your daily essentials.

- 4.** Excess cash flow generated by your assets should be reinvested in income-generating assets.

- 5.** Establish a company to protect your assets and reduce your taxes. Income that an employee earns is taxed as PAYE and you then get to spend what is left. Income that a company earns gets taxed after the company deducts its allowable expenses, commonly known as net income (total income less allowable expenses). This is the biggest legal loophole that the rich use!

- 6.** Work to learn, don't work to earn. Find a job that will teach you the art of starting your own business. Surround yourself with people who are smarter than you, and pay them well.

- 7.** Every rich person has lost money at some point. Playing not to lose money means you will never make money. "Winning means being unafraid to lose." Failure inspires winners and defeats losers. When something does not work out the way you planned, let it inspire you to try a different approach. Learn and move on.

- 8.** Be in control over your emotions. Do not let fear or opinions of others dictate your actions.

- 9.** Saying "I cannot afford it" shuts down your brain, but asking yourself "How can I afford it?" opens up your thought process and triggers your financial acumen to come up with a creative solution.

- 10.** Pay yourself first, not last. Each month, use a standing order to first invest a certain amount of money into income-generating assets before you pay your bills. If you come up short, use this pressure to pay to inspire you to come up with innovative ways to get enough money to pay the expenses or reduce your expenses. This is a difficult, but important, principle. If you pay yourself last, you would feel no pressure, but you would probably not come up with new sources of income either.

03

PERSONAL FINANCIAL PLANNING

Six steps of financial planning and setting SMART goals

Personal financial planning involves managing your spending, saving, and investing activity. Personal financial planning is imperative for financial wellbeing, to live comfortably, have financial security, and achieve your financial goals. However poor or wealthy you are today, if you fail to manage your finances properly, the probability of your getting into financial difficulty is extremely high. Trying to live up to a style of living that you cannot afford will only lead to disaster. Your financial plan should include the goals, resources, and responsibilities of the entire family. You can achieve family needs but not necessarily what each family member wants. The financial planning process has six steps.

1. Determine your current financial status:

In order to get a perspective of where you are, you need to prepare a list of all your monthly earnings and expenses. Once you have a record of your income and expenses, you will have a good understanding of where your money is going. It is also very useful to identify the assets (what you own in money terms today) and liabilities (money you owe to others today) at this point. A good way to manage your personal finances is to use personal finance software or tracker apps. Some are available free of charge. Most likely, you may find that whatever you earn, you spend, but do not despair. I call this stage of building wealth as "poor" even if you earn ten thousand rupees a month or hundreds of thousands of rupees a month. It represents a state of mind.



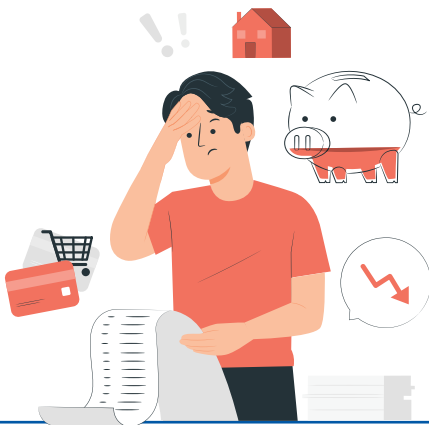
2. Develop your family financial goals:

The next step in financial wellness is establishing financial goals. Establishing your goals is the conscious effort of examining, defining and writing down what you want to achieve both financially and personally. Set SMART (specific, measurable, achievable, rewarding and time-bound) goals. Think of what you want in life and set goals towards achieving them. Your goals can be short-term (one year or less), medium-term (two to five years). For example, if you want to buy a piece of land in 5 years' time, start saving for it now. Alternately, goals can be long-term (more than five years) such as having a comfortable retirement. If you are working for something that's important to you (rewarding), you are more likely to succeed if you have a goal and a time-bound plan of action.



3. Identify your options - your needs and your wants:

Knowing the difference between your needs (something you must have to survive) and your wants (something you desire but can do without). Plan to meet your basic needs before thinking of luxuries. For example, ensure that your children's books are bought before you spend money on new electronics such as TVs, luxuries such as expensive clothes and eating out, etc. Many people spend money they don't have to buy things they don't need, to impress people they don't like. Do not let your emotions control you when it comes to spending money. Financially independent people do not care if their friends change their phones. It does not impress them if their friends go out for dinner every weekend.

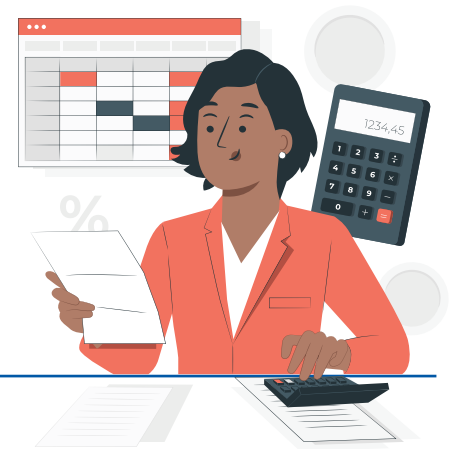


4. Decide what is important to you:

The financial goals you set earlier will discipline your financial management and set you on course to achieve your goals. The trade-off is the opportunity cost or what is given up when making one choice instead of another. Obviously, you will need to sacrifice short-term pleasure if you are to achieve your long-term goals. For example, having a future retirement fund vs. momentary pleasure of smoking: If you smoke three cigarettes daily at Rs.50 each, that adds up to Rs.54,750 a year. If you stop smoking, you will save Rs.54,750 a year, and if you invest Rs.54,750 a year over 30 years at 10% compound interest per annum on a NSB fixed deposit, you will have a Rs.12 million retirement fund in 30 years.



5. Develop a budget: Step one would have enlightened your financial position. It is normal to have your expenses exceed your income, your liabilities be greater than your assets, or your goals far outweigh your ability to save. Once you have decided on your priorities, find out how much you need to pay for them. Make sure you plan not to spend more than you earn. The way forward would be to develop a budget. Keeping in mind that prices usually increase over time, diligently work on achieving your financial goals, which means planning where you will get the income. If you cannot get enough money from your income, raise additional money through part-time work, home-based projects, etc. You will have to cut your expenses and build income-generating assets. Look for ways to spend less so that you can save some money to help you reach your financial goals. Breaking old spending habits will be hard, but as long as you keep reminding yourself of your goal, you will stay motivated. A relatively painless way to find money for savings or debt reduction is to take it right off as you get your income. What you don't see, you won't miss and can't spend.



6. Be vigilant, measure and monitor your progress, and revise your plan: Keep records of your goals and mark off key milestones as you achieve them. Refer to this information from time to time. Writing down goals, reviewing them, and recording your progress can motivate you. Financial planning continues as you follow your plan. As you get older, your financial goals and needs will change. That means that your financial plan will have to change too. You should re-evaluate and revise it every year.



Why financial planning is important ?



- 1.** A disciplined, planned process is the best way to build wealth
- 2.** Helps to avoid "get-rich-quick" schemes
- 3.** Will ensure realistic goals are set and then a self-controlled approach can be applied towards achieving those goals
- 4.** Forces you to think and plan about long-term goals
- 5.** Changes and adjustments can be made easily along the way once a plan is in place
- 6.** Gives clarity to stakeholders (spouse, children, heirs) should the need arise.

04 BORROW SMART

Questions to consider before you decide to borrow from any financial institution:

At some point in your life, you may need to borrow money (take a loan). It is imperative that you borrow smart if you want to maintain your financial stability.

When considering taking a loan for any purpose, do not fail to consider the following factors and ask questions from the lender to clarify any doubts. Shop around for the best offer from different lenders considering these factors.

The single most important consideration is to verify whether you have the disposable income or surplus necessary to accommodate the repayments of the loan every month or week? This is a question any credit officer who interviews you will need to know and on which he will base his decision on how creditworthy you are. If you are able to prove that you have the capacity to repay your loan commitments, then you will need to give the financial institution a standing order for the automatic deduction of the monthly or weekly repayment from your account with the financial institution (FI) or for a transfer of the specified amount to be made from the bank with which you have your account.

"The single most important consideration is to verify whether you have the disposable income or surplus necessary to accommodate the repayments of the loan every month or week?"

Other key considerations would be:

1. Do I really need to borrow? Would I be better off saving for this item and paying in cash in the future? Every loan comes with a cost. The effective interest rate for borrowing is always higher than the annual deposit rate. The effective interest rate is called the annual effective rate (AER).
2. What will be the down payment? Down payments minimize the amount you have to borrow. The more money paid upfront toward the purchase, the more money you will save over the life of the loan.
3. The purpose of the loan – Is it for a productive purpose where the investment made will be able to generate an income for me, which will enable me to absorb the cost of the loan repayment? Will I really have the ability to generate sufficient income or save money from the investment made by taking the loan?
4. What are the security or collateral (something you own) and guarantees required by the lender? Remember that if you fail to pay back your loan, the lender has all the legal rights to take over the collateral provided or request the guarantor to pay back your loan. Lenders that do not require security may charge

very high interest rates because it is very risky for them to give out a loan that has no security. In case you are offered a loan without security, make sure you understand all the terms and conditions including the cost of the loan.

5. What is the total cost of credit and effective interest rate that I will be charged for the loan? The effective interest rate takes into consideration the term of the loan or the frequency with which you are required to pay back the interest and installment of the loan. Usually it is monthly but can be weekly or daily for micro-finance loans with no collateral.

6. Interest computations – Fixed or variable, flat or declining? How will the interest be calculated? Will I be charged a fixed interest rate that will remain the same throughout the term of the loan or a variable interest rate that will periodically increase as a result of increases in market interest rates during the term of the loan? A fixed rate, although higher than a variable rate, allows you to accurately predict your future payments. Variable interest rates may lead to you having to pay a higher monthly payment in the future at the discretion of the lender, if market interest rates increase. Interest may also be calculated based on flat or on declining basis. A loan with 15% declining interest will cost you less than a loan with 15% flat interest. This is because with a "declining" interest rate, you only pay interest on what you actually owe the lender while with a "flat" interest rate you keep paying interest on the original amount of the loan until this amount is entirely paid back.

7. What are the additional fees that may be charged? For example, some loans have front-end fees, stamp duty, early repayments fees, loan processing fees, etc. These can be negotiable and some financial institutes (FIs) waive these charges just to be able to win over customers. So, look around at other FIs before you make a decision about your transaction partner. It is a very competitive market from which you can benefit if you take the trouble to shop around for the best deal.

8. What penalty interests and fines will be charged if you miss an installment payment?

9. What will be the tax impact of taking the loan? Currently, there is a 5% tax on all deposit interests but no tax concession for interest paid on any loan including housing loans by individuals. Business profit is taxed after interest paid is deducted. Hence, it is beneficial to borrow for a business.

When making a decision to take a loan, add the monthly payment amount to your monthly budget. Consider the guidelines above when inserting the figure for the new purchase. If the amount of the payment for the purchase exceeds the recommendations, does not allow you to save money, or causes your monthly expenses to exceed your monthly income, you may want to postpone your purchase until you have more money saved, find a more affordable and comparable item, or pay off other debts.

Annual effective rate is calculated as: $AER = [(1+r/n)^n - 1]$ Where: n = number of times a year that interest is paid and r = nominal interest rate

AER gives the borrower an idea of the true cost of borrowing and is comparable against annual interest rate received on maturity of a fixed deposit at the end of one year. For example, a nominal interest rate of 15% paid monthly is equivalent to $[(1+0.15/12)^{12} - 1]$ an AER of 16.075%.



If you do not devote adequate time to the above imperatives before you take a credit decision, you will invariably find yourself in a debt trap from which you will find it increasingly difficult to extricate yourself.

Asking the right questions will show the credit officer and FI that you are smart and cannot be taken for a ride. If not, the FI will take advantage of your financial ignorance. Don't let this happen under any circumstances. Get all the terms of the loan clearly specified in an offer letter that you can then compare with what is offered by other FIs. This will also give you enough material and information to make the right decision in your favor.

How to protect yourself from aggressive lenders/loan sharks

Beware of aggressive lenders. Avoid "easy" loans from lenders who entice you to borrow and discourage you from reading and understanding the loan documents. They might try to take advantage of you. Always insist on reading all the loan documents and ask for explanations so that you understand all the conditions attached to the loan before you sign. It is your right to ask and the responsibility of the lender to provide you all the information you need before agreeing to take a loan. Both you and the lender should be honest in disclosing

information to avoid nasty surprises in the future. Always look for the fine print and the disclaimer clauses, and question the FI on why these clauses should be there in the first place.

Most lenders calculate the periodic installment payment using a standard formula (given below). There is a big difference where the loan installment and the interest rate are quoted on yearly, monthly, and weekly basis

Periodic installment calculation: $P \cdot \left[\frac{r(1+r)^n}{(1+r)^n - 1} \right]$ where

P = is the principal amount borrowed

r = is the periodic interest (if annual interest rate it is divided by number of installments)

n = number of installments for a year

For example, periodic installment for a Rs.10,000 loan over a 12-month period at 15%

annual interest (1.25% per month) is $-10,000 \cdot \left[\frac{0.0125(1+0.0125)^{12}}{(1+0.0125)^{12} - 1} \right] = \text{Rs.902.58 per month.}$



Yearly interest rate: If you took a loan of Rs.10,000 for one year with 15% interest per annum, you would pay a monthly installment of Rs.902.58. Your payment would be Rs.10,831 plus any other fees/charges: You will pay a total interest of Rs. 831 plus the Rs.10,000 that you received as a loan. The effective interest rate is 16.1%.

Monthly interest rate: If you took a loan of Rs.10,000 for 12 months with 5% interest per month, you would pay a monthly installment of Rs.1,128.25. i.e. $-10,000 \cdot \left[\frac{0.05(1+0.05)^{12}}{(1+0.05)^{12} - 1} \right]$ Your total payment would be Rs.13,539.05 plus any other fees/charges. You will pay total interest of Rs. 3,539.05 plus the Rs.10,000 that you received as a loan. The effective interest rate is 79.6%.

Weekly interest rate: If you took a loan of Rs.10,000 for 52 weeks with 2% interest per week, you would pay a weekly installment of Rs.311.09. i.e. $-10,000 \cdot \left[\frac{0.02(1+0.02)^{52}}{(1+0.02)^{52} - 1} \right]$ Your total payment would be Rs.16,176.72 plus any other fees/charges. You will pay a total interest of Rs.6,176.72 plus the Rs.10,000 that you received as a loan. The effective interest rate is 180.0%.

The poor who have no collateral to offer and are financially ignorant are the most vulnerable to aggressive lenders and loan sharks that offer monthly or weekly interest rates. Due to a lack of alternatives, sheer poverty and helplessness, they are deceived into accepting monthly or weekly payments, as the installments appear tolerable. They will hardly question the total interest payable that is the true cost of borrowing, which is reflected in the effective interest rate charged by the lender.

Before you take a loan, ask the lender about the total amount you have to pay back over the entire period of the loan. This is called the total cost of credit and includes the amount you borrowed + interest cost for the whole period + any other fees/charges. If you shop around for the best lender, you will most likely end up paying less with better repayment terms. Borrowing from the wrong lender could cost you a lot, so research your options and choose wisely. Be confident when asking financial institutions for total cost of borrowing and terms and conditions so that you make an informed decision that is best for you.



It is easy to get into debt but hard to get out

If you borrow money, plan carefully how you will use your loan and how you will pay it back – and stick to your plan. Always use borrowed money for the purpose you borrowed it. Avoid borrowing to pay off another debt unless it reduces the total cost of credit. Borrowing more to pay your existing loans will get you deeper into the debt trap so that it becomes even more difficult for you to get out.

To pay back your loan, you have to make your money work for you. Borrow for productive investments such as buying a piece of land that appreciates. Alternatively, you can grow something or expand your business prospects with that money. Pay back the loan and maybe borrow more later, if it is necessary. Use loans wisely and never rush into borrowing. Think twice before borrowing for luxuries, or things that lose value (e.g. foreign travel, vehicles, household electronic items, expensive clothes, etc.). Borrowing for consumption is totally unproductive.

"Avoid borrowing to pay off another debt unless it reduces the total cost of credit. Borrowing more to pay your existing loans will get you deeper into the debt trap so that it becomes even more difficult for you to get out."



If you think you will fail to pay on time as laid out in the contract, inform your lender in advance and re-negotiate your loan. Do not try to buy time by paying with a cheque that "bounces" (issuing a cheque when you do not have enough money on your account is a criminal offence). Do not give any false or misleading information.

Do not borrow because others are borrowing. It is not wise to take a loan just because other people around you are doing so. Ask yourself if you really need the loan. Mostly, it is better to save than to take a loan. Take a loan only as a last resort.

When's the last time you saw a high interest credit card balance move much lower after making a payment? When you get into high interest debt, you are now fighting against the inevitable force of compounding interest. Nobody makes a real fortune overnight, and nobody goes broke in one night either. The exceptions to the rule regress back to where they should be over time. That's why lottery winners oftentimes end up broke years later.

The habits that you live with define your wealth. If your spending habits cause you to fight against interest, you will fight that fight the rest of your life.

Manage your credit cards wisely

It is easy to get a credit card, but managing it is not easy. Using credit cards is borrowing money. You need to repay what you borrow. Using credit cards requires a very high degree of financial discipline to pay your full balance outstanding on the due date every month, on each card, without fail. Do not ever spend more than what you can afford to pay in full each month. If you fail to pay your balance in full each month, interest will accrue at the rate of 28% per annum or 2.33% per month and get added to the total amount you owe the following month. Thereafter, your outstanding balance will continue to grow fast until you reach your credit limit due to interest on interest. You cannot make progress in your financial life borrowing money at 2.3% per month and you may not be able to get out of the debt trap. Poor use of your credit card can rapidly place you in debt. Paying off debt can take several years and lots of sacrifice. Credit card debt is something you bring on yourself and it is much easier to stay out of trouble than get out of trouble.

The wise use of a credit card is to take advantage of the interest-free credit period allowed by the FI to repay the amount outstanding. It gives you at least 3 weeks to repay especially when you do not have the funds available at the time you need to make a purchase. Most people do not understand this basic concept. You lose nothing and the bank does not earn anything out of your credit card if you have a standing order for the payment of total amount outstanding on the due date.



"Poor use of your credit card can rapidly place you in debt."

At least here, the bank is the loser and you emerge the winner. If you actually calculate the date on which your credit card purchases get billed in your statement for repayment, it can even give you a much longer period than 3 weeks of interest-free credit.

The total number of active credit cards in the country as at April 2022 stood at 1.97 million, whilst the total amount the card holders owed to commercial banks was Rs. 138.19 billion. The numbers imply that approximately one out of every 20 persons in Sri Lanka carry a credit card.

The key to avoiding credit card debt is to make a habit of charging only what you can afford. Once you start using your credit card to fund a lifestyle that is above your means, you risk getting into credit card debt. The more credit cards you have, the easier it is to get in over your head. Many cardholders have two to three different cards and when one card is 'refused' after reaching the maximum spending limit, a second or third card is used.

Financial institutions do a great job convincing you that you absolutely need their money and that you should enjoy life with enticing advertisements that offer a

host of products and services at discounted prices. They even go to the extent of offering 12 to 60 months' interest-free installment payments to persuade you to borrow. However, that lifestyle you enjoy will be short-lived. The irony is that luxuries tend to become necessities and you will reach a point where you will become trapped in a rat race for your entire adult life, living paycheck to paycheck just to afford those luxuries and the long-term price you pay for them is huge. Some have committed suicide because they were neck-high in debt. One of the main causes for high debt among the younger generation is consumer credit that lures you to spend more than what you earn and ultimately devastates your financial future. You may vehemently deny that you are trying to keep up with the neighbors or social class, but unconsciously it is happening due to the consumerist society we live in. What is truly required is a minimalist lifestyle and to live within your means with strict financial discipline. Make sure that you spend your money on what is important and meaningful for you, and simplify your lifestyle. Purchase only what you need without using consumer credit, which in practice means you will have to really think whether the purchase makes sense before you purchase and wait longer to buy things.

Beware of mistaking discounts for value to you. In other words, don't buy something just because it's discounted off its normal list price; buy it if it is something you really need and is a price you can afford. If you see that a Rs.60,000 TV is now on sale for a 50% discounted price of Rs.30,000, and you buy that TV, don't think that you've just saved Rs.30,000. On the contrary, what you have done is that you've just spent Rs.30,000 of your limited cash. Similarly, hotel stays are offered with as much as 50% discounts for credit cards for you to splurge on holidays that you do not actually need or cannot afford.

When making use of interest-free credit card installment payments, bear in mind the consequences of missing even one monthly payment. Missing payments could lead to the financial institution charging you a hefty late payment fee as well as interest at the standard rate of 2.3% per month on the entire amount outstanding even if part of that has been settled. Various fees such as over-the-limit fees, etc. will increase the total cost of your charges.

Do not always carry your credit cards with you. Having a credit card can give you easy access to money you would not typically have. If you leave the card at home, you may think twice about buying items you don't really need.

Of course, if you have reached a stage where your assets generate income that cover more than your expenses and can afford to pay off your monthly credit card balances in full and have the financial discipline to stick to your budget, you can have your credit cards. You can indulge in attractive seasonal promotions and rewards offered by credit card issuers to suit your lifestyle.

"Don't buy something just because it's discounted off its normal list price; buy it if it is something you really need and is a price you can afford."

Debit cards and mobile wallets that debit your bank account as you purchase an item are a more sensible and convenient way to buy your daily essentials without carrying cash and going to the bank or ATM to get cash frequently. Debit cards and mobile wallets also provide a measure of safety from theft. They offer the advantage of not carrying large amounts of cash for high value purchases and avoiding the negatives of a credit as you can utilize only the funds you already have in the account or mobile wallet.

05

HOW MONEY WORKS

The secret to financial success

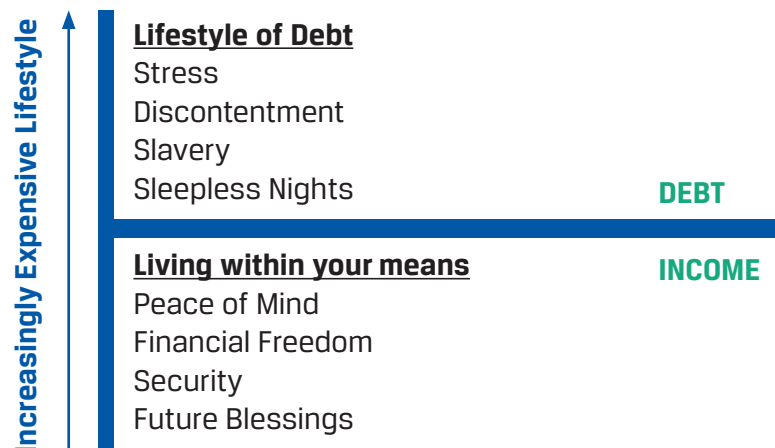
The secret to financial success lies in whether you live within your means. The amount of money you save on a regular basis and prudently invest during your working years matters. If you budget properly and live within your means, you will see a positive cash flow that will allow you to determine what you can afford so that you don't reach too high, lest you fall. If you are earning more than you are spending, you have everything you need to build your wealth so that you can live comfortably later on. The most important thing that determines whether you will be financially successful is controlling your spending or living within your means.

How you build your wealth will be a function of what your current lifestyle needs are and putting a fixed amount away before spending, which will grow for the future. This will be a function of your investment goals and a function of your risk tolerance.

In other words, whether you live within your means (not buying what you want but only what you need and can afford within your income level). Remember the proverb, "The wise man saves for the future, but the foolish man spends whatever he gets." No matter how wealthy you are, you have to monitor your spending and have an idea of how much you are spending compared to your income. Irrespective of whether you are an executive earning Rs. 200,000 or a driver earning Rs. 35,000 a month, if you are spending more than you get, you are bound to get into difficulties.

Too much debt makes it that much harder to reach your goals. Having monthly loan obligations means that the money needed to service those loans can't be used for something else, something that increases your wealth. The deciding factor is whether your thoughts are living in the past, present or future, which will make the difference

The Consequences and Rewards of your Financial Choices



in your financial behavior. People who live in the past may be more cautious but also less likely to default on debt. People who live in the present tend to focus more on the moment and less on changing their financial situation. People who live in the future may feel that they can predict the future, which could lead to taking on too much debt or making bad investments. None of the above time perspectives is a perfect scenario, and just like everything else in life, each perspective has its pros and cons. But the optimal scenario is to strike a balance among all three. Creating a balance between present desires and future goals will ensure happiness both now and in the future.

People sometimes ask me for help after they realize that things have gone out of control. All these people have one thing in common: Not necessarily age, occupation, or lifestyle choices. The trait that they all share is that they are unhappy. Here's where one cannot hide from the "buy now, pay later", instant gratification mentality. There is a price to pay for your spending decisions and the price can be steep. People who choose to live beyond their means while they are working are likely to pay a hefty price during their golden years for their spendthrift ways at a time when they need the money most for their retirement.



Foregoing smart financial planning during the working years, when you have both time and resources on your side, means you will be in for a rude awakening when you realize that you are staring at retirement with depleted savings. What was supposed to be a time of leisure suddenly looks pretty bleak, with a few decades of retirement ahead and little money to draw on.

Make your savings work for you

There are two ways to make money: One way is to work for money, which is what we all do. Another way is to get your money to work for you by saving and investing, which we all neglect to do. While money doesn't grow on trees, it can grow steadily when you save and invest wisely. You don't have to be a genius to save and invest your money. You only need to know some basics and the determination to be prudent about your finances.

When your money goes to work, it may earn a steady income. For example, a borrower pays you to use your money for a period of time. When you get your money back, you get it back plus "interest." Or, if you buy stocks in a company that pays "dividends," the company may pay you a portion of its earnings on a regular basis. Your money can give you an "income," just like you. You can make more money when you and your

money work together. Just like you demand extra wages with increasing inflation, you have every right to demand an adequate return or wages from the borrowers for using your money depending on the risks you have to take. The second way is if you become an owner of something that you hope increases in value over time. When you need your money back, you sell it provided someone else will pay you more for it. For example, you buy a piece of land thinking it will increase in value as that area gets developed with new roads, housing, etc. You expect to sell the land in five, ten, or twenty years when someone will buy it from you for a lot more money than you paid for it. And sometimes, your money can do both at the same time—earn a steady income and increase in value, such as buying a property that generates rental income as well as appreciates in value.



"There are two ways to make money: One way is to work for money, which is what we all do. Another way is to get your money to work for you by saving and investing, which we all neglect to do."

The differences between saving and investing

Saving

Saving is the practice of setting aside part of your current earnings for future use. You have to sacrifice current spending to save for a better future. When you save regularly over a long period, your money will "grow".

Savings are very helpful in addressing unexpected or unforeseen problems such as illness, accidents, unemployment, robbery, drought, funerals, floods that destroys your belongings or crops, etc. In such situations, your savings can help you to recover. Make sure that you keep money for emergencies. If you ever have to use part of your emergency fund, top it up again as soon as you can. A cash reserve of 2 months of your income in savings would help to meet these unforeseen occasions. In addition to providing a safety cushion, a cash reserve reduces the likelihood of you getting into debt.

Keeping your savings safe

If you are very risk-averse, and keep your money under the mattress or in a pot buried in your kitchen, you may still find that your money has been stolen or eaten by moths or lost its value. No matter where you save, make sure that your money is safe. Usually, you put your savings in places where you perceive as safe and that allow you access to your money at any time. Most people use saving accounts at licensed banks and finance companies regulated by Central Bank of Sri Lanka (CBSL) to keep their savings safe as they are more reliable. Remember none of these institutions are 100% safe because if the institution becomes bankrupt you may get only part of your money (amount of compensation



payable to a depositor of licensed financial institutions is limited to Rs.600,000 under the deposit insurance scheme of CBSL) and that too after a long delay. Further, there is a tradeoff for ready availability. Your money is paid a low wage as it works for you. There is hardly any effort required on your part to look after your savings. The value of money in savings accounts gets eroded over time due to inflation. A Rs. 1,000 in 1980 is worth only Rs. 89 today in real terms. In other words to buy the identical basket of food items you bought in 1980 for Rs.1,000 you need Rs. 10,240 today.

Therefore, what you perceive as "safe" is not very safe because of default risk and a more subtle loss of purchasing power over time due to inflation. If you leave all your money in a savings account for a long time, they can subject you to a considerable loss of purchasing power as the interest they earn doesn't keep up with inflation.

For example, if you had invested Rs.1,000 in 1980 in an NSB Savings account and earned interest at the average savings rate of 9.67% for 20 years, the balance in the savings account would be Rs.6,335, thus losing Rs. 3,905 (10,240 – 6,335) in purchasing power.

It is like saving enough to buy a loaf of bread, and 20 years later when you withdraw that money plus the accumulated interest you earned over 20 years, you find that the money can only buy half a loaf.

This is why you need to invest part of your money to earn more over long periods of time, say three years or longer. Most smart investors keep only enough money in savings products to cover unexpected or unforeseen expenses.

Investing

Investing is the current commitment of money for a longer period to generate a future return that will reward the investor for (1) the period of time the funds are committed, (2) the expected rate of inflation, (3) risks – that is the uncertainty of the future. Investing is putting your money to grow. An investment can be in the form of tangible assets (such as livestock, gold and property, and your own business), and intangible assets (such as debentures, unit trusts and shares of another business).

Investing, at its heart, is a deeply optimistic activity. It requires you to forego the enjoyment of your money today in the hope of earning a lot more to safeguard your lifestyle in the future. When you "invest," you have a greater chance of losing your money than when you "save" in the short term. The money you invest in fixed deposits, unit trusts, government treasury bills and bonds, and corporate debentures and stocks can increase as well as decrease in value. You could lose your "principal" – the amount you invested. But you also have a greater opportunity to earn more money. Of course, there is no gain without pain: Greater effort and hard work is required on your part to carefully identify the risks involved prior to investing.

Compared to saving Rs.1,000 in a NSB savings account for 20 years, where you earned an interest of Rs.6,335, the return for investing Rs.1,000 in a default risk-free treasury bill for 20 years for a risk-averse

investor would be Rs.16,520 giving an additional Rs.10,185 over the NSB savings account and Rs. 6,280 over inflation for deferring consumption. Similarly, for a risk taking investor investing in 1,000 shares, if the share price moves from Rs.36 in 2006 to Rs.302.70 in 2022, the total return would be LKR 288,829. This enabled the team to allocate over Rs.372,000 for risk taking and proper select selection. Simply adopting a buy and hold strategy of a few good stocks can make an enormous difference in your future life style.

"Investing is the current commitment of money for a longer period to generate a future return that will reward the investor for (1) the period of time the funds are committed, (2) the expected rate of inflation, (3) risks – that is the uncertainty of the future."



Compound interest is your greatest friend

The biggest weapons you have to fight inflation are:

1. Compound interest.
2. Length of time you allow your assets to grow before you retire.
3. The portion of your return that is greater than inflation.

Future Value calculation: $PMT \cdot \left[\frac{(1+r)^n - 1}{r} \right]$ where

PMT = monthly payment

r = is the monthly interest (if annual interest rate it is divided by 12)

n = number of months

For example, monthly payment is Rs.287 over 30 years (360 months)

at 12% annual interest

(1% per month) is = $-287 \cdot \left[\frac{(1+0.01)^{360}}{0.01} \right] = \text{Rs. } 1,003,054.71.$



You could become a millionaire (Rs.1,003,054) by simply saving Rs.287 per month at 12% (interest compounded monthly) for 30 years. Although, you only saved Rs.103,320 (287x 360 months), the balance Rs.899,734 is interest on interest. The effects of a simple 4% difference in the rate of return generated by an investment over a 30-year time horizon would lead to your ultimate wealth being over 2 ½ times greater: That is if you get 16% interest compounded monthly, you will end up with Rs.2.5 million $-287 \cdot \left[\frac{(1+0.0133)^{360}}{0.0133} \right].$

Know the rule of 72: Divide 72 by the interest rate and the result is the number of years it will take to double your investment. If you earn 6% interest on your money, it will take 12 years ($72/6$) for your original investment to double in value and if you earn 12% interest, it will take only 6 years for your original investment to double in value. What is most important is how much real returns (interest rate less inflation rate) that you could generate. Thus, higher the real return (return over inflation), you get from your investment, the richer you become. It should be clear to you now the importance of your striving for the highest possible real returns on your investments, whilst protecting yourself from risk. Bear in mind that if the bank or the company defaults, you lose all your money, which is why diversification and finding out the default risk is so important.

It is time for Sri Lankans to shift from savings to investing and to take charge of their financial destinies. Gone are the days where you viewed the stock and bond market as a pastime of the idle rich "playing" the market, an elite version of gambling. Investing is serious business, a necessity for accumulating the money essential for retirement or other financial goals.

Compounding interest at its core is best served by conservative investing. Someone who chases speculative and very trendy stocks won't see the power of compounding interest. How can you when your capital moves up and down wildly, growing fast and then crashing hard to remove all your gains?

"Investing is serious business, a necessity for accumulating the money essential for retirement or other financial goals."



Some investments are too good to be true

Beware of investments that look too good to be true, as they will most likely end up in total loss to you. Don't get taken in by "get rich quick schemes" such as pyramid schemes (where you are promised payment if you introduce more members to the scheme). TV commercials, newspaper advertisements and salesmen calling on you promote a variety of investment options and financial services. The unscrupulous often talk highly of the returns offered to appeal to your greed and rely on your ignorance of risk. You need an independent third party to clarify risk. Do not believe the sales talk! You will often hear "your investment is guaranteed. There is no way you can lose money."

Make no mistake, the borrower itself cannot give a guarantee, because the borrower is anyway legally required to repay the loan on its due date. Only a financially strong third party can give a guarantee that if the borrower defaults they will come forward and repay the loan. If a loan or investment is guaranteed, the guarantee by the third party should be unconditional and irrevocable, enforceable under all circumstances. In other words, the guarantor should not be able to find a way out of not honoring the guarantee when the borrower defaults. Do not yield to high-pressure

"Beware of investments that look too good to be true, as they will most likely end up in total loss to you. Don't get taken in by "get rich quick schemes" such as pyramid schemes (where you are promised payment if you introduce more members to the scheme)."

sales tactics: Thoroughly investigate the investment product offered and find out the risks involved before investing. Genuine borrowers will be happy to provide you with independent analysts' research reports and credit ratings, etc. and give you time to make an informed decision. Most importantly, you should invest in only licensed, regulated financial institutions. However attractive the proposition may be, if it is not a licensed regulated FI, you do so at your own risk. Further, be very suspicious of individuals who claim to be representing well-known organizations who may take your money giving you fake certificates.

Once invested, you need to continuously monitor your investments to ensure that they are earning the return needed to meet your goals and are within your risk tolerance level.

Follow your investments to keep you involved and educated about the markets and the trends driving interest rates and stock market.

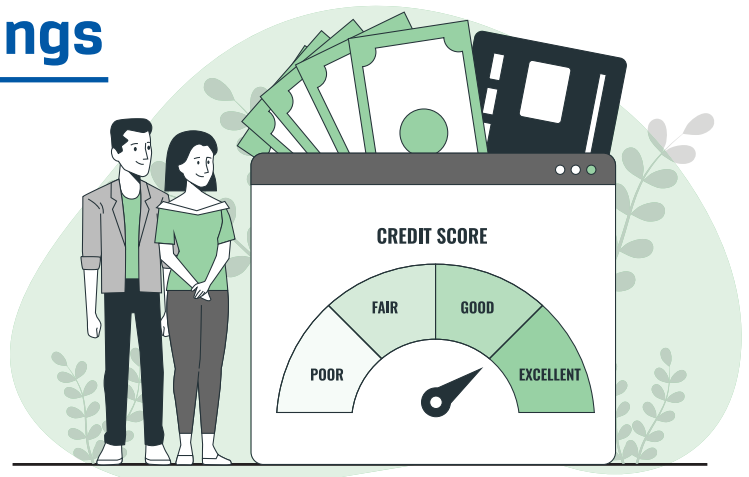


Understand credit ratings

A credit rating reflects a carefully formed independent opinion of the ability to service the promised interest and principal payment on a timely basis by an entity (in other words, the default risk). Default risk is the risk that the borrower will be unable or unwilling to meet payments of interest and principle in full and on time.

The opinion of the agency is published in the news media for the benefit of the public. Credit ratings are not guarantees against loss. Neither are they recommendations to buy, sell or hold securities, which have to be based on many other market and investor-specific considerations. They are simply opinions about relative measures of default risk. Credit ratings are mandatory for all banks and finance companies that solicit public funds in Sri Lanka. You have the right to demand to know the credit rating of any deposit-mobilizing financial institution and do not invest in any financial institutions that do not have a credit rating.

"Default risk is the risk that the borrower will be unable or unwilling to meet payments of interest and principle in full and on time."



Credit ratings are issued by credit rating agencies (CRAs). They fall under the purview of the Securities and Exchange Commission of Sri Lanka (SEC). Currently, three agencies, Fitch Rating Lanka Ltd (FRL), Lanka Rating Agency Limited, and ICRA Lanka Ltd are registered with the SEC and provide credit ratings.

Ratings provide a relative ranking for measuring of default risk for a given borrower or an issue in comparison with all other rated instruments. At the top of the scale, AAA (Ika) rating means that the risk that the issuer will default is extremely low, and as one descends the scale, the risk of default increases, and at the lower end of the rating spectrum the probability of default is much greater.

Table 1 shows the long-term bond rating scales and their definitions from a domestic currency perspective. In addition to the rating, a detailed credit analysis report is published by credit rating agencies.

Most investors in fixed income instruments have no means of evaluating the default risk or risk of full or partial loss of their investment. In addition, they have no means of comparing the default risks of many potential investment return opportunities available to them. When one invests in any investment product other than a government bond, which is risk-free, there is an element of default risk. Default risk is due to the institution failing to honor its commitment present in bank savings and fixed deposits, corporate bonds or debentures, insurance claims, and finance company deposits.

Whether one is investing in a bank, finance company deposit, corporate bond, debenture, or an insurance policy, investors can use credit ratings to determine whether the risk of that investment meets one's own risk-tolerance level and the return offered is sufficient for the risk one is taking. If you fail to verify the risk using a simple tool such as a rating (which is free) when making above mentioned investments, you are making a huge mistake.

Without knowing the rating, the investors will have to make their investment decisions based on the popularity of the institution. A majority of the investors in Sri Lanka only have a vague idea of the risk involved in investing as they do not undertake a thorough investment appraisal. They continue to assume that the government will come to their rescue if the institution goes bankrupt. Most of them only look for returns, and the default risk is rarely considered. In Sri Lanka, we have not had banks defaulting but have had several finance companies that failed where depositors lost their money.



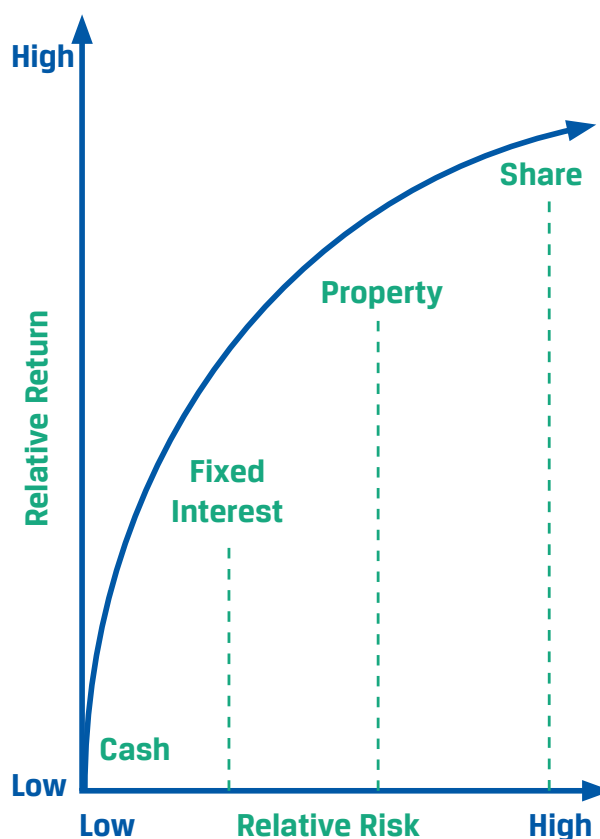
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Table 01 - Debt Rating Scale for Sri Lanka

Rating	Definition
Investment Grade	
AAA (ika)	Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to adversely affected by foreseeable events.
AA+ (ika) AA (ika) AA- (ika)	Very high credit quality. 'AA' ratings denote a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ (ika) A (ika) A- (ika)	High credit quality. 'A' ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in economic conditions than in the case for higher ratings.
BBB+ (ika) BBB (ika) BBB- (ika)	Good credit quality. 'BBB' ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.
Speculative Grade	
BB+ (ika) BB (ika) BB- (ika)	Speculative. 'BB' ratings indicate that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.
B+ (ika) B (ika) B- (ika)	Highly speculative. 'B' ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payments is contingent upon a sustained, favourable business and economic environment.
CCC (ika) CC (ika) C (ika)	High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favourable business or economic developments. A 'CC' rating indicates that default of some kind appears probable. 'C' ratings signal imminent default.
DDD (ika) DD (ika) D (ika)	Default. Securities are extremely speculative, and their worth cannot exceed their recovery values in any liquidation or reorganisation of the obligor. 'DDD' designates the highest potential for recovery of amounts outstanding on any securities involved. For example, 'DD' indicates expected recovery of 50% - 90% of such outstanding amounts, and 'D' the lowest recovery potential, i.e. below 50%.

Know the risks of investing

Every investment comes with a risk. Risk is the possibility that the investment's actual return will be different than expected, and includes the possibility of losing some or all of the original investment. In fixed interest products such as fixed deposits and debentures, you have default risk and purchasing power risk (the returns being lower than inflation where you cannot buy the same amount of goods that you could have bought before with the maturity proceeds of the investment). Investments in shares, unit trusts and gold have market risk or volatility (day-to-day fluctuation of prices due to behavior or sentiment of investors and other factors). Property investments have liquidity risks where you may not be able to quickly convert them to cash. It is important for you to know your risk tolerance: The amount of psychological pain you are willing to suffer for your investments. If you are talking to a professional investment advisor, he or she will provide you a general idea of all the risks involved even before he or she talks about the returns. The opposite will be true for unscrupulous advisors.

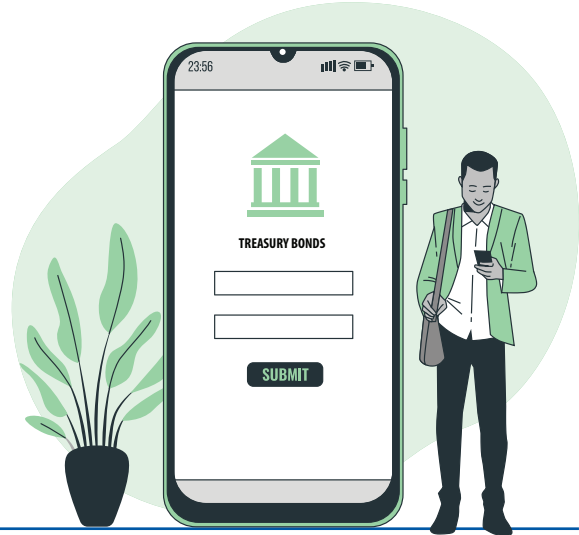


"Every investment comes with a risk. Risk is the possibility that the investment's actual return will be different than expected, and includes the possibility of losing some or all of the original investment."

Investing in the capital market

Types of investments

Bonds popularly called debentures in Sri Lanka are used by entities such as the government, financial institutions and companies to borrow or raise debt. Institutional and individual investors invest (lend money) to them for payment of interest where there is an agreement to payback the principal borrowed at a specific future date. Debentures can be bought and sold from the Colombo Stock Exchange (CSE). Their value can rise or fall over time.



A **share** represents part ownership of a company. If you have shares in a company, you may receive dividends from the profits the company makes. The price of a share usually changes over time. If the price of a share increases, it will be worth more than the price at which you bought it. But if the price falls, it will be worth less than what you paid. The price of a share depends both on the performance of the company concerned, dynamics of the industry the company operates in and on the general economic situation.



How to invest

In order to reduce the risk and maximize the return of your investment, the following are vital.

Have a strategy for your financial future

Having a well-planned investment strategy can make all the difference. Without a strategy, there is a tendency to act impulsively, for an example, panic sell following a steep decline in the stock market. A tool many investors use is the investment policy statement (IPS), which spells out investment objectives and constraints, i.e. return requirements, risk tolerance and constraints (time horizon, liquidity needs, laws and regulatory restraints, taxation, unique preferences and circumstances of the client). A professional investment advisor will try to understand the client's needs and develop an IPS and document the responsibilities of all parties in managing the investments. Based on your investment goals and risk tolerances, the IPS will recommend a suitable asset allocation that the investment advisor will manage for you. The IPS will be reviewed and updated regularly as and when the client's objectives, constraints or circumstances change.



Diversify your investments to reduce risks

Different asset classes have different levels of risk and return characteristics, and they behave differently under the same market conditions over time. Therefore, the positive performance of one asset class can offset the negative performance of another asset class. Hence, investors need to diversify across asset classes and within an asset class.



Review your portfolio regularly

Regularly review your portfolio to ensure that the portfolio provides the diversification you require. Reassess the returns of your portfolio against benchmarks in order to keep track.



Price is what you pay; value is what you get

Keeps things simple, only invest if you understand the future earnings potential of the asset you are investing in. The fact that a given asset has appreciated in the recent past is never a reason to buy. Owners of stocks, however, too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally as well. A climate of fear is your friend when investing; a euphoric world is your enemy.

Investors tend to think of 'risk' in predominantly negative terms, as something that should be avoided. However, in the investment world, risk is inseparable from performance and rather than being undesirable, risk is simply necessary. Understanding risk is one of the most important parts of financial education.

Your objective should not be to invest in the least risky alternative such as an FD, but to obtain the best possible return commensurate with the risk you are willing to bare. This is only possible if you are willing to learn and get professional advice. If not, you will end up taking higher risks than necessary unknowingly and losing money like most investors do today.



Benefits of investing in the capital market

1. Capital appreciation - Investments in listed securities such as shares, debentures or unit trusts can provide greater long-term returns than savings accounts and FDs in the form of capital gains and dividends. Securities prices over the long-term tend to outperform inflation.

Period	No of years	Average return p.a. (%)	Average 1 year treasury bill yield (%)	Risk premium from shares
1985 - 2012	28	26.59	14.29	12.30
2002 - 2012	11	32.98	11.56	21.42
2009 - 2012	4	53.53	11.33	42.20

2. Liquidity and flexibility - Shares and debentures can be sold easily at the prevailing market price and do not incur significant transaction costs or time. Securities are traded in units and lots that are affordable by investors of different income levels.

3. Diversification - The range and variety of securities listed in stock exchanges provide investors an opportunity to minimize their exposure to specific company risk by spreading their investments across a wide selection of securities. This benefit is made more real by Unit Trusts, which invest pooled savings using specialized professional expertise that is beyond the ability of an individual investor.

4. Collateral - Securities can be used as collateral to secure financing such as loans from lending institutions.



History has repeatedly shown that investors who stick to a sound strategy for the long-term come out ahead. Despite many short-term crises, stock markets have historically recovered – driven by long-term consistent company earnings growth.

Get professional advice when making investments

When investing, seek professional advice from an investment expert, who is not incentivized on up-front commission, who has a proven track record, a high level of competence and is bound by a rigorous code of ethics and standards of professional conduct that is strictly enforced by a globally recognized institution. You should not entrust your life savings to a smooth-talking sales person. Equally, you should never entrust your money directly to an adviser. Instead, use a custodian such as a large reputable bank. This reduces the opportunity for fraud, since the adviser does not directly handle your deposits or withdrawals.

Do some due diligence before you select an investment advisor. You could contact the SEC for a list of licensed professional investment advisors, or talk to a colleague who has been successful in making investments. However, do not blindly trust any "expert." He/she may be trying to sell his/her own products in order to receive a commission. Try to get various opinions and trust your own informed judgment. Choosing an investment advisory firm (often described as a stockbroker, fund manager, or wealth manager) that helps you to build your investments is the single most important decision you will make as an investor. It does not matter if you are a beginner or have been investing for many years; it is never too late to ask questions.



"When investing, seek professional advice from an investment expert, who is not incentivized on up-front commission, who has a proven track record, a high level of competence and is bound by a rigorous code of ethics and standards of professional conduct that is strictly enforced by a globally recognized institution."

Before you decide to invest your hard-earned money with an investment advisor who you can trust and feel good about, there are a few questions you should ask.

- 1.** Does the investment firm have the required licenses and can they provide client references? A good first step would be to check with the CSE or SEC. Secondly, speak to a few of their existing clients.

 - 2.** Does the investment advisory firm manage investments with prudence, taking fundamentals into consideration, with a goal of providing clients returns that are consistent with their risk-tolerance levels?

 - 3.** Does the investment advisory firm provide a clear understanding of the risks of the investment? Listed below are some questions you could ask in order to get a better idea of the risks.
 - a. How will this investment make money? Specifically, what must happen for this investment to increase in value?
 - b. How much does this investment have to increase in value before I break even?
 - c. How easy would it be to sell if I needed my money urgently?

 - 4.** Does the investment firm maintain compliance and risk management systems, information security and controls to protect client information?

 - 5.** Has anyone in the firm been disciplined by any government regulator for unethical or improper conduct or been sued by a client for the breach of fiduciary responsibilities?
-

These questions are not exhaustive. However, they will help you identify an investment firm that will best meet your personal investment objectives. A good investment advisory firm should welcome such questions from its potential clients, no matter how basic, because a good investment firm knows that an educated client is an asset, not a liability.

06

WEALTH MANAGEMENT

Wealth management is about matching an investor to a portfolio. It is not stock picking or investing cleverly. A concentrated portfolio faces greater risk of loss than a well-diversified one. Wealth management begins by understanding yourself, understanding markets, and finding a balance between capital preservation and future growth in your investment portfolio. Managing wealth is not about getting rich quickly or speculating on the stock market. Wealth management is a well-considered journey to prosperity. As people get richer, the task of managing and retaining wealth becomes more complex.



"A concentrated portfolio faces greater risk of loss than a well-diversified one."

Asset allocation and portfolio diversification

When investing, an individual investor should always take a portfolio approach. Which means that he or she should evaluate individual asset classes and securities in relation to their contribution to the investment characteristics of the whole portfolio that is suitable for that particular individual's circumstances. Portfolio diversification helps investors avoid disastrous investment outcomes. It is well known that many retired people had put most of their money in a particular finance company in Sri Lanka that went bankrupt. They were financially ruined, and could not even meet their medical expenses and passed away. The lesson is "not to put all your eggs in one basket," or in other words, take a diversified portfolio approach and reduce the risk associated with your wealth without necessarily decreasing their expected rate of return.

Many poor people invest in gold, which they pawn when they need money and the wealthy invest in land, houses or apartments. They misguidedly assume that their values only go up.

There are numerous instances in the world where prices of gold and real estate have crashed, and such assets had to be sold at a substantially lower price than their original purchase price to generate cash for emergencies such as ill health.

That is where the portfolio of diversified asset classes and further diversification within each asset class help to manage risks. It will help you stay invested in turbulent times and help you avoid the dangers of over exposure to a few asset classes and taking on an imprudent amount of investment risk.

Portfolio investment options for an individual investor could comprise of several asset classes. For example, fixed income instruments such as government treasury bills and bonds, listed corporate debt instruments, local and foreign listed stocks, and cash and cash equivalents. All these asset classes are liquid or easily convertible to cash. In stocks too you have two classes: There are growth stocks and income stocks. Income stocks are less risky as they provide a steady income stream, i.e. dividends even in down markets. You also need to have some liquidity in your portfolio. The norm is to have an amount equivalent to your expenses for 3-6 months in the money market or in quickly cashable savings instruments. In addition, your investment portfolio could comprise of less liquid assets, such as real estate, precious metals such as gold, art, and various alternative investments, (for example, private equity).

A professional investment advisor will construct a portfolio with a target asset allocation based on economic and capital market expectations, security analysis, and client's objectives and constraints as set out in the IPS. Asset allocation is an art as well as a science. It's the investment alchemy by which you balance several ingredients for the proper mix of risk and reward. What matters is the risk and return characteristics of different asset classes and correlations between these asset classes: For example, when interest rates go up, stock (and property) markets come down. The opposite occurs when interest rates come down. What the advisor will try to achieve is a broadly diversified portfolio that is best suited for that particular client to protect his or her wealth against unpredictability of the future.

"What matters is the risk and return characteristics of different asset classes and correlations between these asset classes: For example, when interest rates go up, stock (and property) markets come down. The opposite occurs when interest rates come down. What the advisor will try to achieve is a broadly diversified portfolio that is best suited for that particular client to protect his or her wealth against unpredictability of the future."



Risk management

Risk management is an important part of the portfolio construction process. What is important is not the risk of any single security or asset class, but rather how all the asset classes perform in the portfolio. To evaluate an investment, you should consider the different risks that could affect its performance.

Market risk considers a broader picture. If you invest in stocks, you have to accept that the overall economic and political condition of the country, or even world events such as the oil price, war, etc. will cause your investment's value to fluctuate. Market risk is relevant also for investments in single companies, bonds, and alternative investments. A market decline could impede the investment's performance, even if the quality of your investment remains the same. Investments also follow trends. For example, real estate could appear to be a "good" investment, encouraging more people to buy real estate, driving up prices for some time. Once the overall sentiment of investors switches to the belief that real estate is overpriced, your property could lose potential value even though the structure hasn't changed.



"What is important is not the risk of any single security or asset class, but rather how all the asset classes perform in the portfolio."

Default risk as explained previously is related to the quality of the underlying investment, and it is more apparent when investing in a single company, through stocks or bonds. If the company or even a financial institution is mismanaged and goes bankrupt, it is possible you won't receive the promised return or the capital you invested.

Liquidity risk as explained previously is how quickly you can convert your investment into cash, without losing in the process.



Inflation risk is the decline of the purchasing power of the rupee due to inflation over time. Returns from investments that provide safe but low returns may not keep pace with inflation.

Interest rate risk arises when market interest rates change, which can erode the capital of fixed-income instruments. For example, if you invest in a debt instrument at a low coupon rate and market interest rates go up, you may incur a capital loss if you sell your fixed income instrument prior to its full term. Conversely, if you invest at a higher coupon rate and market interest rates decline, you can benefit from capital gains if you sell your investment prior to its full term.



07

BE PREPARED FOR THE UNEXPECTED

Why take insurance

When you get insurance, you take away some of the financial risks of unexpected events. Insurance is a way of financially protecting ourselves, or others, for the payment of money if an expected loss occurs. It removes uncertainty by transferring financial consequences to someone else – usually an insurance company. The insurance company compensates for a specified loss caused by an accident, fire, burglary, illness or death in return for an agreed amount of money paid in advance (this is called a premium). This compensation may also be made to a third party (e.g. if you knocked somebody down while you were driving). If you have life assurance and you die, your family will be paid the amount your life is insured for. Your vehicle or motorcycle must have insurance cover. Insurance only applies when you buy the insurance before the event happens.

The insurance policy is the contract or legal document that explains in detail under what situations and conditions the insurance company will pay you. You will only get paid if the loss is covered by the terms of a particular policy.

Insurance covers risks you cannot prepare for so you don't have to save huge amounts of money. Insurers can predict the number of losses they might have. They won't know exactly, but experience and statistical data will give them a pretty good idea. In fact, only a small proportion of policyholders will actually suffer a loss in any given year.

An insurance company offers its protection by grouping together people who all feel exposed to the same risk. By collecting an amount of money, a premium, from each person, the insurer can accumulate a fund called an insurance pool, out of which losses can be paid.

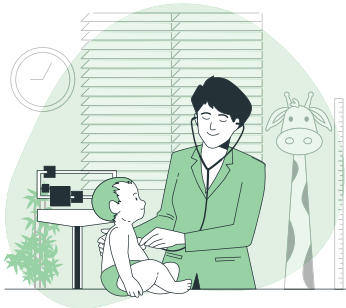


"When you get insurance, you take away some of the financial risks of unexpected events."

Types of insurance



Life insurance is an agreement between an insurance company and an individual, where the insurer promises to pay a certain amount of money to your family or other designated beneficiaries when you die.



Health insurance covers certain medical costs as included in the insurance policy. Make sure you understand which medical conditions and services will be covered and up to which amount. Most policies place a lot of emphasis on what they do not cover and it is very important to have a good discussion with the insurer to find out exactly what medical expenses will be covered and the conditions attached so that your medical claims are sure to be honored by the insurance company and they don't disclaim liability.



Property insurance provides protection against property damage. The person insured is given compensation when damage occurs to the particular property that had earlier been insured. An example is when your house burns down or is damaged by a flood: In such a situation, the insurance company will provide compensation to enable you to replace the lost/damaged property.



Liability insurance provides you with insurance protection if you cause damage to someone's health or property. It only covers the other person's losses. Your person and your property are unprotected, but liability insurance protects you from being held responsible for the other person's damages. For example, if your building collapses as it is being constructed and hits a person thus injuring them, this type of insurance will take care of the medical costs of that person. In addition, the insurance coverage will pay for the person's belongings that were damaged at the time of the accident.



Disability insurance provides protection to you in case you lose your job or are unable to work due to a disability as a result of an accident. If you are insured against disability, then the insurance company will compensate you for your loss of earnings.



Travel insurance provides protection during travel against unexpected situations, such as sickness, injury, if you miss a flight because of reasons beyond your control, or if you lose your luggage.

Do and don'ts when taking insurance

1. Identify the best insurance company

company, consider their paying ability indicated by their credit rating, conditions, processes and the time it would take to have your compensation paid. Get quotations from different insurance companies, agents, brokers and speak to friends who have bought insurance or the Insurance Regulatory Commission of Sri Lanka (IRCSL). Talk to them about your insurance needs. Think carefully about the options, and then choose a policy that meets your needs.

2. Give correct information about yourself for the insurance contract documents.

If you don't give the right information, the insurance company might not pay your claim.

3. Carefully read the contract.

Ask where you do not understand. Only sign when you are satisfied on all points – including the insurance cover and the premiums you will be paying.

4. Make a quick and honest claim.

If you incur any loss covered by the insurance policy, inform your insurance company immediately. When making any claims, always tell the truth. It is a criminal offence to give wrong information. If you give false information, your claim will not be paid.

5. Report thefts, accidents and other damages to the police before going to ask for compensation from the insurance company.

The insurance company may refuse to compensate you if you have no police report to confirm how the accident happened and what property was lost or damaged. For any claim, make sure you keep written proof (e.g. the medical costs and the police reference number). You need to provide information that is important for the insurance company to calculate your compensation.

6. If you think that the insurance company has unfairly refused to compensate you, or has not given you enough compensation, you can complain to the insurance company.

If the insurance company refuses to consider your complaint, or you consider that the insurance company has not responded fairly to your complaint, you can approach the IRCSL or the Sri Lanka Insurance Ombudsman. Their services are provided free of charge.

08 PLANNING FOR YOUR RETIREMENT

Why plan for retirement?

Retirement is the stage where you stop working completely and cease to receive income from your human capital – your salary, or professional or business income. Many people do not stop work completely because they do not plan early enough for their retirement. This forces them to continue working even after the normal retirement age. For formal employment, the minimum age of retirement in Sri Lanka is 60 years. People retire either voluntarily (resign or retire before the minimum retirement age) or involuntarily (forced to retire because of age, fired from work, or forced to stop working due to sickness or disability).

If you are employed in the public sector, you are entitled to a government pension upon retirement. Many people in the public sector retire when they are eligible to get the pension. The problem with the government pension (usually a percentage of the last drawn monthly salary based on the number of years of service) is that it hardly keeps up with inflation. Several years after retiring, when you need the most amount of money for living and medical expenses that have escalated over the years, your government pension received would not be enough to make ends meet.



"Many people do not stop work completely because they do not plan early enough for their retirement."

If you are employed in the private sector, you will have 8% of your salary deducted and sent to Employees' Provident Fund (EPF). Your employer must also make a 12% contribution of your salary to the EPF and 3% contribution of your salary to the Employees' Trust Fund (ETF) every month. It is always important to get your statements from the EPF and ETF to ensure that your money is being saved every month. Your total contributions to EPF and EPF returns can be withdrawn when you reach the age of retirement. Further, your total contributions to ETF and returns thereon can be withdrawn every five years. The investment policy of both funds are focused on providing a long-term positive real rate of return to the members, while ensuring the safety of the fund and availability of an adequate level of liquidity to meet refund payments and other expenses of the fund. The EPF investment portfolio consisted of 93.2 percent in government securities, 3.8 percent in stocks, 0.8 percent in corporate debentures and the remaining 1.8 percent in fixed deposits as at end 2021. The problem with EPF is that it has provided a low return i.e. around 9-10.5% per annum for the period 2017 to 2021; prior to this since 1980s, the average return stood at 11.5% to members and even lower by ETF (however, you are eligible for other benefits such as life insurance and medical expenses while contributing to ETF but not after you withdraw your money).

When you consider the average annual inflation per annum of 10.4 % for the same period 1980 to 2017, you will realize that the real rate of return you received from EPF of 1.1% (11.5% less 10.4%) over the same period, is quite small. Therefore, your monthly saving of 23% of your salary over your working life will not grow to an adequate sum where your final withdrawal amount would be enough for a comfortable retirement.

A substantial proportion of the Sri Lankan labor force (over 27%) is made up of self-employed persons and workers engaged in the informal sector and they do not have any pension or provident fund scheme. They are left to fend for themselves even when incapacitated by age and disability. Many of them are left without any source of income of their own to fall back on and are forced to rely on family support. As such, many of them are faced with a bleak future in the twilight years of their lives.

Therefore, everyone needs to plan for his or her retirement. The earlier you start, the higher the probability of you reaching your retirement goal. It will be a useful addition to your pension or provident fund investment income after retiring. If you are not getting a pension or provident fund income, these savings and investments will be your security for old age.

It is important to ask yourself how much income you will require when you retire to be able to maintain yourself and any dependents you may have during retirement. Planning early, by saving and investing wisely, will help you meet your needs during retirement.

Key challenges of investing for retirement

There are three key issues.

1. Firstly, what is the size of the nest egg you will need when you retire? That is when you have to live with your investment income. I use a simple rule called the "Thousand Bucks Rule": if someone who thinks they will live about 20 years after retirement wants Rs 1,000 per month, they need Rs 240,000 as principal (i.e. $1,000 \times 12 \times 20$), ignoring inflation; if they need Rs. 100,000 per month, they must have Rs 24 million available as capital ignoring inflation. If you need Rs.200,000 per month, you must have Rs.48 million and so on to generate the investment income to live.
2. Secondly, how can you preserve your capital without losing your original investment or principal, because investing involves risks or volatility of returns? That is, your investments may not bring the desired outcome or expected returns.
3. Thirdly, how can you protect your capital from inflation that erodes your principal or purchasing power?

Sri Lankans enjoyed high interest rates until recently and had got used to high interest-paying bank and finance company deposits as the primary mode of investing for retirement. However, since the end of the two decade civil war, interest rates have declined over 50% and rates are most likely to remain low going forward. However, with the onset of the ongoing macroeconomic challenges and pandemic induced constraints, interest rates have noted an increasing trend driven by the contractionary monetary policy. Unlike deposits, when investing, you have to bear the risk of the value of your principal fluctuating due to market volatility. Many

investors in Sri Lanka still think they cannot live with that risk. Going forward, it will be more accurate to say they will not be able to live without it. Without a carefully measured amount of risk in an investment portfolio, you either have to massively increase your savings to reach your retirement goal, or accept that you'll end up with less at the end.

Assuming you invest Rs.1,000 per year for 25 years in a 12-month fixed deposit at NSB that pays a 6.5% annual interest, you will end up with Rs.58,888. In comparison, if you invest in a portfolio of 60% stocks and 40% bonds that provide a return of 16% per annum for shares and 8% p.a. for fixed income instruments, you will have Rs.150,866 in 25 years, that is about 2.5 times more of retirement savings.

The danger of investing in stock markets is not losing the principal invested as most investors in Sri Lanka presume. The more serious risk is that you will react to your losses by selling during a period of market decline, thereby denying yourself the benefit of a recovery. That is where the balanced portfolio of both shares and fixed income instruments comes in. It will help you stay invested in turbulent times, it will give you a good dose of the stock market's higher long-term return potential, and it will help you avoid the dangers of not taking on a prudent amount of investment risk.

"Without a carefully measured amount of risk in an investment portfolio, you either have to massively increase your savings to reach your retirement goal, or accept that you'll end up with less at the end."

Wisely manage your savings in retirement

Most people spend much of their working lives saving for their future. Yet, after so many years of being disciplined about saving, you may find it difficult to transition from working and saving to retiring and spending from your hard-earned nest egg once in retirement. It is absolutely imperative that you understand that the EPF, ETF and gratuity you have received after you retire is for you to invest wisely in a diversified portfolio of investments so that you generate sufficient monthly income for you to live on for the rest of your life. It is not for you to spend and bust it doing things that you could not do previously for short-term gratification such as buying luxuries or spending a large proportion of the money received on things that do not generate a monthly income, which most financially illiterate people seem to do in Sri Lanka. Make no mistake, if you do, you will run out of money, as you will no longer have a steady paycheck to support your expenses.

Create a realistic spending plan.

It is just as important to establish a plan for living through retirement. There is a balance to strike here – you do not want to run out of your savings too quickly, but you also do not want to miss the opportunity to enjoy this time in your life. It is important to be realistic about how you spend, as you will want to be able to manage it properly. At other phases in life, you might think of this concept as a budget, but, in retirement, try to think about it as a spending plan.

"Allocating your expenses into needs, goals and aspirations can help provide a better framework for managing your cash flow and living comfortably."

Allocating your expenses into needs, goals and aspirations can help provide a better framework for managing your cash flow and living comfortably. To do this, itemizing is an important step. No different than what you would do at other phases of your life, you'll need to budget your daily living expenses such as housing, utilities, food, and healthcare. Next, consider goals and aspirations, which might include visiting grandchildren, foreign travel, hobbies, or even larger purchases. You might also wish to make charitable donations or leave a legacy for your family. Be sure to prioritize your desires according to what is most important to you.

Determine a withdrawal strategy that is right for you.

Once you have your spending plan, you will want to figure out how to draw down from your assets. Have a "bucket" of guaranteed income consisting of pension, monthly fixed deposit interest, and annuities. This could cover needs such as housing, food, utilities, travel, medical expenses, and insurance. Allocating your funds to these necessities can provide a sense of financial security knowing that you'll still be able to pay for life's basic necessities, even if you spend money for foreign travel or non-essential items.



The amount you withdraw can also vary at different stages of your retirement. For example, you may want to withdraw more early on when you are more active and perhaps want to travel or enjoy leisure activities. Later, when you are less inclined to be active, you may need a smaller income to support your lifestyle. You can also do just the opposite – take it easy on the withdrawals in your early years and maybe even supplement your income with a part-time job. Then, as you feel more comfortable about your income stream, gradually increase your withdrawals. As medical expenses tend to increase with age, this can also be a smart approach for many people. The beauty of a flexible withdrawal strategy is that you can adjust based on your personality and individual goals.

Be mindful of the unexpected. While it is important to map out a strategy for a spending plan and withdrawal approach, it is just as important to prepare for the unexpected.

With life expectancy increasing and health-care costs rising, medical expenses are also critical to a retirement planning strategy.

Remember there is no medical insurance once you reach the age of 70 years.

"Having a will and perhaps a living trust that are regularly updated will give you more control and make it easier for those involved to manage your legacy. Working with a lawyer can help determine whether a will or a trust makes sense for you."

Protect your legacy. Have a nominee for all your fixed deposits and have a joint current account with your spouse, son or daughter, or a sibling just in case you pass away suddenly. You may want to make sure your wealth will be used in a way that corresponds to your core values. Remember, your estate consists of everything you own including cash, investments, life insurance policies, and personal property. Having a will and perhaps a living trust that are regularly updated will give you more control and make it easier for those involved to manage your legacy. Working with a lawyer can help determine whether a will or a trust makes sense for you. As part of this process, it is also a good idea to confirm your beneficiaries. These designations on your accounts can supersede your will, so make sure those who are noted are the ones you want to inherit your wealth. If you fail to do so, your loved ones will have to spend time and money on a testamentary case or, even worse, the financial institutions or the government may very well inherit your wealth. There are billions of rupees of unclaimed funds with financial institutions.





09 CONCLUSION

This booklet is about becoming more successful in managing your finances, in a way that enables you to get more from your money and accumulate wealth. It provides you the minimum financial wisdom you should have for your adult life.

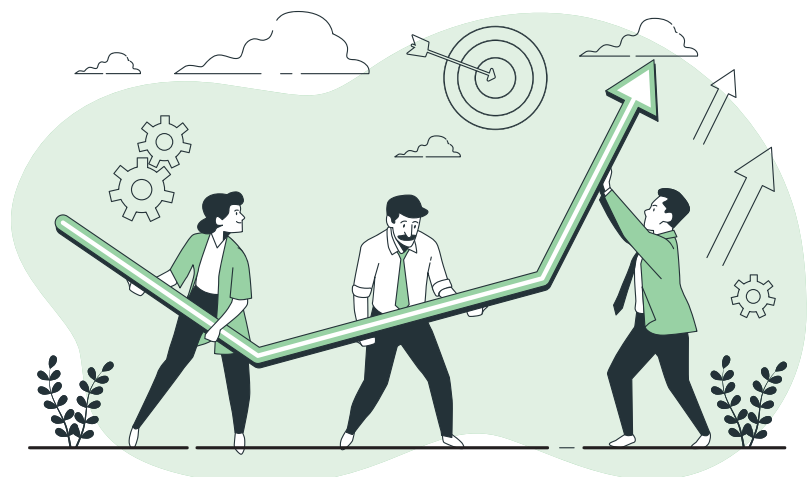
Most people are unprepared to deal with rapid changes in the financial landscape. There is a proliferation of financial products from credit products to mobile wallets, many of which entice people to spend money they do not have, which – if they are not restrained – could put them into difficulty. Governments are pushing to increase financial inclusion by boosting access to financial services, but unless people have the necessary financial skills, these opportunities can easily lead to high debt, mortgage defaults, or insolvency. This is especially true for young people who suffer from low financial literacy.

"Most people are unprepared to deal with rapid changes in the financial landscape. There is a proliferation of financial products from credit products to mobile wallets, many of which entice people to spend money they do not have, which – if they are not restrained – could put them into difficulty."

A retirement crisis looms in Sri Lanka as it is one of the fastest ageing populations in the world and individuals will have to take a bigger role in retirement planning. People do not seem to be prepared, as they lack the financial skills needed to deal with the economic challenges of retirement.

Research has found that financially savvy adults are less likely to have problems with debt and more likely to save for retirement and other reasons.

As a result, policy makers should consider stepping up the effort for financial education. Given the importance of financial literacy in today's economy, helping all adults acquire financial knowledge in school and the workplace can prove particularly successful. Research has shown that targeted financial literacy programs that are focused on specific behaviors and populations can lead to smarter financial decisions.



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2. Independent and **objective** advice and assistance based on informed analysis, prudent judgment, and diligent effort;
3. My financial **interests** taking precedence over those of the professional and the organization;
4. **Fair** treatment with respect to other clients;
5. Disclosure of any existing or potential **conflicts** of interest in providing products or services to me;
6. **Understanding** of my circumstances, so that any advice provided is suitable and based on my financial objectives and constraints;
7. Clear, accurate, complete and timely **communications** that use plain language and are presented in a format that conveys the information effectively;
8. An explanation of all **fees** and costs charged to me, and information showing these expenses to be fair and reasonable;
9. **Confidentiality** of my information;
10. Appropriate and complete **records** to support the work done on my behalf.

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Ravi Abeysuriya is the CEO/Director of Senfin Securities Limited, Chairman of Colombo City Holdings PLC, Sherwood Capital (Pvt) Ltd and an Independent Non-Executive Director of Seylan Bank PLC, HNB Assurance PLC, and Bio Foods (Pvt) Ltd. He is also the Advocacy Chair and Board Director of CFA Society Sri Lanka. Formerly, he was the CEO of Candor Group, Head of Strategic Business Development of Hayleys Group, Managing Director of Amba Research Lanka and Managing Director of Fitch Ratings Lanka.

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Beginners Guide To
**FINANCIAL
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